are forward looking; thus costs for unbundled network elements should be recovered on a total service long run incremental basis, plus any necessary loading of forward-looking common costs.[84]

D. The Commission Must Construct A Clear Mechanism For Addressing Requests for Additional Unbundled Network Elements

NCTA disagrees with commenters who would leave to negotiations the unbundling of network elements beyond the minimum set established by the Commission.[85] Nor should the Commission adopt proposed standards for analysis that are not supported by the Act and would significantly limit the degree of unbundling that otherwise would be required. For instance, Ameritech claims that in order to qualify as a network element, it must be a feature, function, or facility "that the incumbent uses to provide a telecommunication service."[86] The definition of network element is not limited to features, functions or facilities "the incumbent uses." Rather it is a broad definition encompassing features, functions, capabilities or equipment used in the provision of telecommunications services.[87]

Moreover, there is no evidence to warrant the adoption of proposals to impose on CLECs the posting of bonds or the payment of liquidated damages in order to enforce agreements for unbundled network elements.[88] Nor should the Commission allow ILECs to price unbundled

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[84] NCTA Comments at 49-50; NCTA Pricing Study at 12; NCTA Pricing Study Reply at 4-5, 13-14.

[85] Ameritech Comments at 31; NYNEX Comments at 64-65; Bell Atlantic Comments at 24.

[86] Ameritech Comments at 32.

[87] 47 U.S.C. § 153(29).

[88] See BellSouth Comments at 35-36. Nor should the Commission give any weight to arguments that networks and technology vary from carrier to carrier, and thus a presumption that if an element is technically feasible for one carrier to provide other carriers can provide that same element as well, cannot be sustained. Pacific Telesis Comments at 55. As the Commission recognized, there is minimal variation in equipment design from State-to-State. Notice ¶ 79. This is also supported by the common unbundling requirements adopted by many states. NCTA Comments at 35.

elements in a way that discourages their use.[89] Allowing the imposition of bonds or liquidated damages on new entrants, full set-up costs on the first purchaser of an unbundled network element, or applying standards of review beyond that required by the Act to determine the "economic reasonableness" of requests, would serve only to create barriers to obtaining unbundled network elements in an expeditious manner.[90]

The Commission should adopt its tentative conclusion that requests for unbundled network elements will be presumed reasonable to all network element requests.[91] Such a policy recognizes the affirmative obligation on ILECs to provide unbundled network elements, and the ILECs' power and incentive to abuse any process designed to address requests for elements by competitors.

E. CLECs Should Not be Required to Unbundle Their Networks as a Condition of Obtaining Unbundled Access to ILEC Network Elements

There is neither statutory support nor an economic rationale for imposing reciprocal interconnection and unbundling obligations on CLECs.[92] Bell Atlantic's contention that reciprocity of interconnection and unbundling requirements is necessary to "put a 'real world' check on potentially unrealistic -- or purely tactical -- unbundling requests" is nonsense. In the "real world," CLECs are required to pay for the network elements and interconnection they order, which is all that is necessary to deter frivolous requests. CLECs, even if they had the

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89/ Bell Atlantic Comments at 18.

90/ NCTA Pricing Study Reply at 13.

91/ Notice ¶ 87.

92/ Bell Atlantic Comments at 20-21; U.S. West Comments at 70.

inclination, do not have the resources necessary to engage in the rampant "tactical" ordering feared by Bell Atlantic.[93]

In any event, the plain language of the 1996 Act precludes imposition of ILEC requirements on CLECs at this time. While Congress gave the Commission authority to reclassify a new entrant as an ILEC, it restricted the exercise of that authority to situations where the new entrant occupies a comparable position in the marketplace; has "substantially replaced" the incumbent; and such treatment "is consistent with the public interest, convenience, and necessity and the purposes of [Section 251]."[94] To date, no CLEC has attained anything close to the market power enjoyed by ILECs. Nor has any CLEC "replaced" -- substantially or otherwise -- an ILEC.[95]

F. The 1996 Act Requires that ILEC Resale Rates be Based on Existing Retail Rates

Paramount among the 1996 Act's goals is the promotion of facilities-based competition.[96] Facilities-based competition encourages innovation and the deployment of new

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[93] DOJ Comments at 23. Moreover, as DOJ observes, only where a firm has attained market dominance through use of a bottleneck facility -- as is the case with ILECs -- should it be required to deal with potential rivals. Id. CLECs have neither the incentive nor the ability to engage in such anticompetitive behavior.

[94] 47 U.S.C. § 251(h)(2).

[95] Differential regulation of ILECs and CLECs does not infringe on the ILECs' equal protection rights under the Fifth Amendment. Cf. Comments of U S West, Inc. at 35-37. Courts will defer to statutory classifications found in economic legislation as long as they are rational. Federal Communications Commission v. Beach Communications, Inc., 113 S.Ct. 2096, 2101 (1993); see also Illinois Bell v. Federal Communications Commission, 740 F.2d 465, (7th Cir. 1984) (subsequent history omitted). As the Commission has long held, the distinction between carriers with market power and those without it does not violate equal protection clause. In the Matter of Tariff Filing Requirements for Nondominant Common Carriers, Memorandum Opinion and Order, 8 FCC Rcd 6752, 6754 n.21 (1993), vacated on other grounds 43 F.3d 1515 (D.C. Cir. 1995), citing see, generally, City of Auburne, Texas v. Auburne Living Center, 473 U.S. 432, 439-442 (1985).

[96] See 47 U.S.C. § 271(c)(1)(A); House Report at 76-77 See also NCTA Comments at 26-30

technologies and provides consumers with choices in price and service. Resale is valuable as a transition to facilities-based competition and as a means for facilities-based providers to fill out their service territories.[97/] Congress established a wholesale rate for the resale of ILECs' retail services -- the retail rate minus "avoided costs" -- that appropriately balance the goal of facilities-based competition and the benefits of resale.[98/] The Commission should reject efforts to deviate from this standard.

MCI, for instance, derives a 34 percent discount off of retail rates by excluding from the wholesale rate costs that the ILEC does not actually "avoid" when it provides services for resale. It would also exclude allocated common costs, even though the avoided cost standard is essentially a measure of short-run incremental costs.[99/] As NCTA suggested in its initial comments, a discount no more of 10 percent is consistent with the statutory definition of "wholesale rate" and will not undermine the development of facilities-based competition.[100/]

For their part, the ILECs argue that residential service should not have to be resold at all because it is priced below cost.[101/] This result, too, would be inconsistent with Congress's intent. Congress deliberately chose to disregard the actual costs of providing a particular service for purposes of calculating resale rates,[102/] in order to avoid the inevitable delay that would accompany any effort to resolve the age-old question of the costs of local service. In the context

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97/ Id. at 28-30.

98/ 47 U.S.C. § 252(d)(3).

99/ See Owen Declaration at 7-8.

100/ Owen Declaration at 27-30, 41; Owen Reply at 7.

101/ GTE Comments at 45; Ameritech Comments at 56; U.S. West Comments at 64-65.

102/ Compare 47 U.S.C. §§ 252(d)(1), (2) with 47 U.S.C. § 252(d)(3).

of price caps, the Commission rejected similar calls for comprehensive cost studies.[103] The Commission should comply with the statutory mandate applicable here and calculate resale prices on the basis of ILEC retail rates.

IV. THE COMMISSION SHOULD RESIST ILEC EFFORTS TO USE THE ACT'S WAIVER PROVISIONS TO DENY RURAL AND SMALL TELCO CUSTOMERS THE BENEFITS OF THE 1996 ACT

The Commission has the authority and the obligation to develop national guidelines to assist the states in determining the criteria for the suspension of Sections 251(b) and (c) for LECs with fewer than two percent of subscriber lines, and the application of Section 251(c) to rural ILECs.[104] Contrary to the suggestion of some commenters that Section 251(f) is "self-executing" and that the Commission need not promulgate standards at all,[105] national standards would reduce disputes, increase efficiency, and promote uniform opportunities for new entry in rural areas across the nation.[106] While USTA and several other commenters agree that the Commission should develop national standards for suspensions, modifications, and exemptions, these proposals would permit broad exemptions from the Act's requirements and contravene Congress's desire to ensure the benefits of competition for customers of small and rural ILECs.

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[103] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, 5 FCC Rcd 6786, 6816 (1990).

[104] See 47 C.F.R. § 251(f)(1)(B). See, e.g., AT&T Comments at 91; Telecommunications Carriers for Competition Comments at 53; Vanguard Cellular Systems Comments at 40.

[105] See, e.g., Pacific Telesis Comments at 99; GTE Comments at 80; Alltel Comments at 16; TDS Comments at 7; Rural Telephone Coalition Comments at 11; Oregon PUC Comments at 31; Pennsylvania Public Utility Commission Comments at 42.

[106] Small Cable Business Association Comments at 14.

A. Congress Intended for the Benefits of Competition to be Available to Rural Americans

Congress intended to provide rural consumers with the same competitive benefits and choices provided to urban consumers.[107] Contrary to comments submitted by rural telcos, Congress did not intend the exception in Section 251(f)(1) to create a blanket prohibition on competition in rural areas.[108] Rather, the provision was carefully crafted to create a narrow, targeted exception for the States to apply at their discretion to address specific, unique circumstances arising in rural areas.

There is no basis for the contention advanced by some rural ILECs that they should be shielded from competition in order to prevent them from losing customers or thwart "cream-skimming" in rural areas.[109] Congress clearly contemplated that the provision of service in rural areas may entail higher costs and create the possibility of "cream skimming." Rather than addressing these concerns by restricting competition in rural areas, Congress chose to establish the specialized and narrowly targeted rural exception of Section 251(f)(1)[110] and the universal

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[107] Senate Report at 61 (Statement of Sen. Burns) ("Through sound legislation, we have jobs creation, while expanding the competitive choices available to all Americans, including rural and small town residents."); 141 Cong. Rec. S7888-7889 (daily ed. June 7, 1995) (Statement of Sen. Pressler) ("[This bill] establishes a process that will make sure that rural and small-town America doesn't get left in the lurch."); id. at S8476 (daily ed. June 15, 1995) (Statement of Sen. Pressler) ("[C]ompetition and deregulation will bring great benefits to South Dakota and other States with small cities."); id. at S8004 (daily ed. June 8, 1995) (Statement of Sen. Dorgan) ("[A]nother part of this bill . . . are the protections . . . for rural America - not protections against competition, but protections to make sure we have the same benefits and opportunities in rural America for the build-out of infrastructure of this telecommunications revolution as we will see in Chicago, Los Angeles, New York, and elsewhere. Our citizens are no less worthy than citizens who live in the biggest cities . . . .").

[108] Such an interpretation of the rural exception would directly contravene the purpose of the Act "to provide for a pro-competitive, deregulatory national policy of advanced telecommunications and information technologies to and services to all Americans by opening all telecommunications markets, to competition." Conference Report at 1 (emphasis added)

[109] Bay Springs Comments at 6, 9.

[110] 47 U.S.C. § 251(f)(1).

service provisions of Section 254,[111] both of which are designed to accommodate these concerns within the framework of a national policy that seeks to promote competitive choice in rural markets.[112] The Commission should not eviscerate this congressional design by transforming the narrow rural exception of Section 251(f)(1) into a general ban on competition in rural areas.

B. Requests For Interconnection With Rural LECs Should Be Presumed Bona Fide

Guidelines that impose burdensome qualifying requirements on new entrants should be rejected as contrary to the core objectives of the Act. USTA and other rural ILECs seek to impose a vast array of needless and burdensome preconditions in order for an interconnection request by a new entrant to be considered "bona fide."[113]

The Commission has previously determined that requirements that force requesting carriers to disclose unnecessary details and commit to minimum service periods are unreasonable and potentially discriminatory.[114] Such provisions also constitute impermissible barriers to entry. In lieu of the burdensome prefiling requirements USTA and the rural ILECs seek to impose on requesting carriers, the Commission should adopt a presumption that any request for interconnection, services, or network elements received from a telecommunications carrier that

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[111] See id. §§ 254(b), (c), (e), (f).

[112] In the same vein, Congress expressly limited the rural exemption so that it does not apply in areas where a telephone company begins providing video programming after the date of enactment of the statute. Id. § 251(f)(1)(C). The Commission should reflect this limitation in its rules.

[113] See Anchorage Telephone Utility Comments at 5; TDS Comments at 6; USTA Comments at 87-88.

[114] Investigation of Access and Divestiture Related Tariffs, Memorandum Opinion and Order, 97 F.C.C. 2d 1082, 1213-14 (1984); see also Illinois Bell Telephone Company Tariff F.C.C. No. 43, Memorandum Opinion and Order, Transmittal Nos. 732 and 744, 1985 FCC LEXIS 3616, at *7 (rel. March 29, 1985) (conditioning bona fide requests with mandatory minimum service requirements and financial commitments not appropriate).

has sought or obtained permission to provide telecommunications services within the State is bona fide. Rural ILECs should bear the burden of demonstrating that the requesting carrier has the intent to injure the ILEC's business.

CONCLUSION

For the reasons set forth above, and as described more fully there, the Commisison should adopt rules that fulfill the mandate of the Telecommunications Act of 1996 to establish a pro-competitive, deregulatory national policy framework for telecommunications.

Respectfully submitted,

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May 30, 1996

CERTIFICATE OF SERVICE

I, Jennifer A. Purvis, do hereby certify that on this 30th day of May, 1996, a copy of the foregoing Reply Comments of The National Cable Television Association, Inc. was hand-delivered to the following:

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C.

In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996	}	CC Docket No. 96-98

Reply Declaration of Bruce M. Owen

Introduction

I am an economist and president of Economists Incorporated, an economic consulting firm located at 1200 New Hampshire Ave., N.W., Washington, D.C. 20036. I discuss my qualifications in a declaration that I previously filed in this proceeding. That declaration focuses on resale and proxy rate issues.

Counsel for NCTA have asked me to comment on several issues concerning proxy rates that have been raised by other parties in this proceeding. I focus on five issues: the possible use of proxies to establish a presumption of legality rather than a price ceiling, the suitability of bill-and-keep as an interim policy for pricing transport and termination, the advisability of basing proxy rates on current interstate access charges, the difficulties potentially encountered in measuring forward-looking costs, and the appropriate level of the reseller discount.

Proxies Should Not be Limited to Establishing a Presumption of Reasonableness

PacTel and Bell Atlantic have suggested that proxies be used only to establish a presumption of reasonableness, not as a rate ceiling. (Comments of Bell Atlantic, May 16, 1996, at 39; Comments of Pacific Telesis Group, May 16, 1996, at 74.) Under this proposal, incumbent local exchange carriers (ILECs) would be free to charge rates exceeding the proxies, but those rates could be challenged in rate reasonableness proceedings.

To comply with the PacTel and Bell Atlantic proposal would be to negate the reason for using proxies in the first place. The great advantage of proxies is that they allow competition to begin before completing the long process needed to establish cost-based rates. (The difficulty of establishing cost based rates is generally recognized. In the words of Bell Atlantic witness Jerry Hausman, "Measurement of costs, no matter how defined, is in my experience labor intensive, time consuming, and contentious." Affidavit of Professor Jerry A. Hausman, on behalf of Bell Atlantic and USTA, May 13, 1996, at 8.) If proxies only establish a presumption of reasonableness, then an ILEC could still establish rates that would prevent competitive entry. Competitive local exchange carriers (CLECs) could challenge those rates, as they were above the proxy level. To show the rate was unreasonable, however, would require exactly the type of long, complicated, regulatory proceeding that the establishment of proxies is designed to avoid. Such an approach would create an unnecessary barrier to entry by increasing the risk and uncertainty facing potential entrants. Thus, unless proxies are established as rate ceilings, ILECs will be able to continue to use their monopoly power to delay competitive entry.

Bill-and-Keep is a Reasonable Interim Solution to Transport & Termination Pricing

Other parties in this proceeding have raised a number of objections to the use of bill-and-keep as an interim method of pricing transport and termination. (See in particular, Rohlfs, et al. "Interconnection and Economic Efficiency," on behalf of BellSouth, May 15, 1996, at 8-10; Affidavit of Robert G. Harris and Dennis A. Yao on behalf of US West, May 15, 1996, at 22-3; Declaration of Robert W. Crandall on behalf of Bell Atlantic, May 16, 1996, at ¶ 12; Affidavit of Professor Jerry A. Hausman on behalf of Bell Atlantic and USTA, May 13, 1996, at 9-10.) These objections overstate the potential problems with bill-and-keep, while ignoring the significant advantages that bill-and-keep would have.

Some have expressed the fear that under bill-and-keep competing local exchange carriers would engage in fraud by pretending that long distance calls, whose termination is costly, are local calls, which can be terminated "for free." To the extent that this risk exists, it pertains primarily to interexchange carriers whose future limited local networks might qualify for transport and termination interconnection. It would not apply to facilities-based competitors in local exchange service, who have substantial local networks, and who would not generally be providing long distance service. The NCTA interim bill-and-keep proposal is limited to facilities-based local exchange carriers, such as cable systems and CMRS providers. In any case, fraud of one type or another is a potential problem with any system. The proper response to the possibility of fraud is to penalize those who engage in it, not to create a barrier to the entry of firms because they *might* behave unlawfully. Finally, to the extent that ILECs qualify to offer long distance service under the 1996 Act, the risk of such fraud is symmetric.

The fear that an interim bill-and-keep system will prevent a carrier from extending its network is similarly misplaced. As noted above, the NCTA proposal is limited to local facilities-based carriers. Moreover, as a carrier considers extending its network to serve more customers, it will realize that those customers will both originate and terminate traffic. Thus, the fact that the carrier will not be paid for terminating calls to its new customers will not deter the extension of its network, because it will be counterbalanced by the fact that it will not have to pay to terminate the calls those customers originate that travel to other carriers' local networks. In general, those opposed to interim bill-and-keep seem unaware of the symmetry in such a system; *both* connecting parties get their calls terminated "for free," not just the CLECs. Of course, the implicit price that each carrier pays under bill-and-keep is not really zero; it is equal to the foregone revenue from the other.

Fears have also been expressed that bill-and-keep compensation will be unfair because traffic may be unbalanced, with one carrier terminating a far larger proportion of the traffic than others. There is no reason, however, to expect traffic to be unbalanced between competing LECs. Nor is there any justification for Drs. Harris and Yao's assertion that on average ILECs will have greater costs of terminating traffic. A firm's share of subscribers will not affect the relative number of calls it transfers to or accepts from other carriers. A carrier with fewer subscribers will terminate fewer calls, but it will also originate fewer calls for termination on competing networks.

Moreover, if an imbalance of terminating traffic (or, more generally, an imbalance in termination *costs*) were to exist, its effects on the supposedly disadvantaged carrier would be minimal. These effects would be limited to the transport and termination costs of the calls it received from other carriers, net of the transport and termination costs of the calls it transferred to such carriers. As discussed in my previous declaration (at 35-38), transport and termination costs are very small; the best estimates range from \$.0026 to \$.0036 per minute.

BellSouth's recent behavior suggests that it is not concerned about imbalances in terminating traffic. In Florida, BellSouth has entered into an agreement whereby a LEC does not have to pay for transport and termination of more than 105 percent of the minutes terminated by the LEC that terminates the fewest minutes on the network of a connecting LEC. Thus, if traffic is unbalanced, the transport and termination charges will effectively be zero for additional minutes of traffic. This agreement essentially institutes bill-and-keep whenever there is significant traffic imbalance, precisely those instances when its opponents suggest that bill-and-keep will be most inappropriate. (Florida Public Service Commission, Prehearing Order, docket No. 950984-TP, issued January 4, 1996.)

A number of other objections center on perverse incentive effects that supposedly arise from bill-and-keep. In particular, concerns have been raised that bill-and-keep might cause CLECs to hand off calls more rapidly than would be efficient or to avoid signing up customers who terminate a particularly large volume of calls, such as pizza delivery services. These objections seem of little practical significance. First, as noted above, these incentives are symmetric; they apply to ILECs as well as to CLECs. Second, the costs of terminating a call are small. Thus, pricing termination at zero instead of its actual cost would have only limited incentive effects, because the actual costs are close to zero. Third, bill-and-keep is proposed here as an interim solution. Thus, firms will have less reason to find ways to take advantage of the supposedly inefficient incentives of bill-and-keep, because they will have no reasonable expectation that bill-and-keep will remain in effect. It takes time for firms to respond to incentives, particularly in this instance, where responding to the incentive would require a firm to structure its network or customer base in a certain way. Firms will not want to expend time and resources in structuring their network or customer base to take advantage of a system that will soon be gone.

Moreover, if bill-and-keep does lead to significant inefficiencies, the ILECs and CLECs will have the incentive and ability to negotiate mutually agreeable and more efficient alternative arrangements. The ability to save the alleged excess costs that stem from bill-and-keep will mean that an agreement exists that leaves both ILECs and CLECs better off (than with bill-and-keep) without higher prices to end users. Because both parties can be better off, they will have an incentive to come to an agreement. This situation can be contrasted to one where the parties are left to work out a transport and termination agreement with no alternative regulatory scheme—no default option—in place. Under those circumstances, the ILEC has a clear incentive to delay the negotiations, thereby slowing the entry of its competitors.

The preceding point can be put somewhat more generally. This is a situation to which the famous "Coase Theorem" applies. The Coase theorem holds that, if transaction costs are low, it does not matter which initial conditions the Commission establishes—so long as it does establish initial conditions—because the parties will bargain their way to an efficient outcome. (R. H. Coase, "The Problem of Social Cost," in *The Firm, The Market, and the*

Law (1988) at 95-156.) An exception to the Coase theorem may arise when one of the players in the market is able to exercise market power, as would be the case if the Commission relied entirely on private negotiations to establish transport and termination agreements. In that case, the ILECs could use their market power to delay the establishment of the agreements, thus delaying the entry of their competitors. Bill-and-keep establishes initial conditions in a way that minimizes transactions costs; therefore, it does not matter whether bill-and-keep is efficient or not. Moreover, bill-and-keep establishes initial conditions that do not facilitate the exercise of market power by the ILECs.

Establishing bill-and-keep as an interim solution to setting transport and termination charges would prevent incumbent local exchange carriers (ILECs) from manipulating transport and termination charges or delaying agreements to exclude competitors, while reducing administrative and transaction costs. These advantages have led a number of state regulatory commissions to establish interim bill-and-keep regimes, as described in my earlier declaration. Moreover, the great administrative simplicity of bill-and-keep has led to its adoption for terminating calls originated by neighboring LECs, as admitted by the BellSouth witnesses.

Although a bill-and-keep arrangement is imperfect, as is any method of regulating the price of transport and termination, it is far superior to allowing ILECs to delay the advent of real competition in telephone service.

Interstate Access Charges are Not an Acceptable Basis for Proxy Termination Rates

Professor Hausman at ¶ 17 of his affidavit endorses using interstate access charges, net of the CCLC (Carrier Common Line Charge) and Residual Interconnection Charge (RIC) as proxies for setting rates. This method is one of several methods for setting proxies on which the Commission requests comments (¶ 139 of the Notice). Access charges are not a suitable starting point for the development of proxies, however, because there is no reason to believe that these charges bear any relationship to incremental costs.

Access charges were originally set in a rate-of-return-regulated environment and were based on arbitrary embedded cost allocations. These cost allocations were designed in part to ensure that LECs made enough profit on long distance calls to ward off a perceived threat to their ability to continue to provide universal service, or perhaps merely in response to the political threat that might have arisen if local rates increased rapidly. In any event, no attempt was made to base these prices on incremental cost. Most access charges were later subject to price cap regulation. Price cap regulation is designed to ensure that LECs have incentives to reduce costs and that consumers' rates fall by at least a predetermined average productivity factor. Price cap regulation was not designed to ensure that specific rates would be brought into line with costs, much less incremental costs.

As NCTA describes in its first-round comments, merely removing the CCLC and Transport Interconnection Charge (TIC) from access charges will not be sufficient to derive acceptable proxy rates. (NCTA Attachment B at 36-37.) It would still be necessary to remove a number of other costs that were included in these charges and that are inappropriate for inclusion in a rate for access by a competing local exchange carrier. In fact, intrastate access charges are so far out of line with actual costs that they are not even a good starting point for developing proxies. Rather than trying to develop proxies based on eliminating certain charges from interstate access rates, the Commission should base proxies on other more reliable sources of information, such as the Hatfield cost model, as described in my earlier statement.

Rates Should be Based on Estimates of Forward-Looking, not Embedded Costs

Dr. Crandall raises the issue of whether rates should be based on measures of forward-looking costs or measures of embedded costs. (Declaration of Robert W. Crandall on behalf of Bell Atlantic, May 16, 1996, ¶¶ 14-17, 20.) In particular, he notes the difficulties in measuring forward-looking costs, which are often estimated based on models of hypothetical networks. He questions whether such networks truly represent an efficient design. (It is not true, as he asserts at ¶ 16, that if there were evidence that building such a network was an efficient use of society's resources, someone would be building them. Absent competition, ILECs have had little pressure to adopt efficient strategies, and their success in blockading entry by denying interconnection to new entrants and through the protectionism of state regulatory commissions has prevented entrants from providing innovative designs.) Further, Dr. Crandall warns that measures of forward-looking costs are prone to a degree of uncertainty.

The mere fact that estimates of forward-looking costs come from engineering models of hypothetical networks does not mean that the Commission cannot rely on them. Every time a business begins an investment project, it relies on an estimate of the costs of building and operating its new investment, often an estimate done with less care than those put before the Commission. Of course, the estimates of forward-looking costs are not perfectly accurate; no such information ever is. To wait for perfect information is to condemn oneself to permanent inaction. Moreover, to the extent that estimates of forward-looking costs are based on existing inefficient network designs, they would overstate the actual costs of the ILECs.

Furthermore, estimates of embedded costs are themselves prone to errors. These estimates are often based on arbitrary accounting techniques. Moreover, there is always the difficult question of whether a given expenditure represents an efficient use of resources. Regulatory commissions over the years have spent enormous resources in prudency reviews and rate cases attempting to answer this question. Thus, there is no reason to believe that attempting to measure embedded costs is any easier than attempting to measure forward-looking costs.

More important, forward-looking, not embedded, costs are the economically relevant concept. Embedded costs relate to past input prices and technology, which have no necessary relationship to current economic conditions, and which will not affect the pricing and output decisions of a firm in a competitive market. Even if embedded costs were known to be completely accurate, an accurate measure of an economically irrelevant quantity should not be preferred to an imprecise measure of the relevant quantity. At least in attempting to measure forward-looking costs, one is proceeding with the proper goal in mind.

Reseller Discounts Should Not Exceed 10 percent

In my earlier declaration, I concluded that, based on the experience in California and Illinois, a wholesale discount proxy for resellers of local exchange service should be no greater than 10 percent. Information submitted in the initial round of comments supports that position. In particular, Sprint's filing in this proceeding includes a study, done by United Telephone Southeast Inc. for Tennessee, of the avoided costs relevant to the reseller discount. It finds that for simple access, avoided costs are 4.76 percent of revenue. For Other (everything but simple access), avoided costs are 7.19 percent of revenue.

A study by J. Christopher Frentrup, submitted by MCI, estimates higher discounts. That study, however, does not use the statutory mandated methodology of basing wholesale prices on retail prices less forward-looking avoided costs This study estimates reseller discounts using historic data taken from Automated Reporting Management Information Systems (ARMIS) reports from 1990 to 1995. It then estimates 1996 and 1997 discounts based on the trend in these data, with no effort to determine how changes in input prices and technology might have affected costs since 1990. Thus, this study is not based on forward-looking costs. Moreover, the cost estimate on which the study bases its reseller discount includes a number of costs that would not be avoided by an ILEC selling at wholesale.

The Frentrup study estimates three categories of supposedly avoided costs: marketing, billing, and collection costs; other costs; and common costs allocated to avoided cost activities. All of marketing, billing and collection costs are included in the estimate of avoided costs, even though an ILEC would incur some costs in marketing to, billing, and collecting from resellers. Furthermore, these costs include a number of categories that are not directly involved with servicing retail accounts and which would not be avoided by selling at wholesale. For example, all the costs of administering investor relations are included in avoided costs, but an ILEC would not avoid the need for investment capital by selling at wholesale.

Other costs are those that Frentrup argues are not related to providing the products that are to be resold. For example, the cost of public telephone terminal equipment is included in avoided cost, because it is not incurred in providing residential or business service. These costs, however, are not avoided by selling to resellers: they are not costs of the service at either retail or wholesale. Thus, these costs should have no role in the calculation of the reseller discount.

Common costs allocated to avoided retail activities are estimated by an arbitrary allocation formula with no attempt to determine if a LEC would really avoid them by selling at wholesale. As the name implies, these costs have no place in an estimate of avoided costs. Avoided costs are a measure of short-run incremental costs. They do not include allocated common costs. By including inappropriate costs in its estimate of avoided costs, the Frentrup study greatly inflates its estimate of the reseller discount

Since my initial declaration in this matter, I have become aware of a tariff proposed by Ameritech in Indiana. One can calculate the reseller discounts implied by this tariff by comparing it to Ameritech's current retail tariff in that state. (Ameritech draft tariff part 22, March 22, 1996; and Ameritech tariff parts 3 and 7, dated July 19, 1995.) This comparison shows that Ameritech's resale rates for business and residential service are about 5 percent below its retail rates. (Higher discounts apply to custom calling features.) Thus, this proposed tariff is consistent with the position that reseller discounts should be below 10 percent.

I declare under penalty of perjury that the foregoing is true and correct.

Bruce M. Owen

May 30, 1996

AN ECONOMIC ANALYSIS OF INTERCONNECTION, UNBUNDLED NETWORK ELEMENTS, AND TRANSPORT AND TERMINATION PRICING ISSUES

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I. INTRODUCTION AND SUMMARY

There are several issues for which economic principles have been misstated or misapplied by incumbent local exchange carriers (ILECs) and their representatives in this proceeding. Four issues stand out as being particularly in need of having principles clearly and correctly stated:[1]

1. *Embedded costs are not proper components of efficient prices.* Economic costs are forward-looking costs. Competition, efficiency, and ultimately consumers will be harmed by a policy that allows ILECs to tax their competitors to recover past expenditures.

2. *Clear federal guidelines governing state arbitration of arrangements for reciprocal traffic exchange, interconnection, and the provision of unbundled network elements will serve the public interest by promoting efficient private negotiations.* ILEC claims that well-defined federal guidelines will prevent private parties from reaching agreements that reflect their superior knowledge of market conditions (including local conditions) are specious and are based on a misunderstanding of the basic economics of bargaining.

3. *The potential efficiency costs of bill and keep arrangements for transport and termination have been overstated.* The ILECs have overstated the potential costs of bill and keep by failing to account for the facts that: (a) traffic direction is not a good measure of the flow of economic benefits; (b) transport and termination is an input into the production of end-user services; and (c) in properly structured negotiations, the private parties have incentives to reach efficient arrangements

4. *New Unbundled Network Elements Should not be Priced in a Way that Discourages their Use.* The pricing scheme put forth by Bell Atlantic maximizes the incentive problems associated with recovering set-up costs for new unbundled network elements.

The remainder of this attachment addresses these four points in more detail.

II. EMBEDDED COSTS ARE NOT PROPER COMPONENTS OF EFFICIENT PRICES

There is widespread agreement that economic costs are forward-looking costs.[2] Competitive firms rely on forward-looking costs to make investment and pricing decisions. Efficiency considerations dictate the use of forward-looking costs as well. The ILECs, however, claim that: (1) the use of forward-

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1 Rather than reiterate a full analysis of the economics of unbundled network elements and transport and termination, these comments focus on those areas where the confusion is greatest. For a complete analysis of the issues, see NCTA Comments, "Declaration of Bruce M. Owen," and "Unbundling, Interconnection, and Traffic Exchange: The Pricing of Access to Local Exchange Networks."

2 See, for example, Ameritech Comments at 60, AT&T Comments at 47-48, and United States Department of Justice Comments at 27

looking costs would result in prices that are too low to allow them to earn the rate-of-return to which they believe regulation entitles them; and (2) that projection of forward-looking costs are too speculative to serve as the basis of pricing. This section discusses why, ILEC claims notwithstanding, forward-looking costs are the appropriate basis for pricing.

A. Recovery of Costs in Excess of Forward-Looking Costs will Distort Consumption and Investment Levels

Because they are not economic costs, the recovery of embedded costs leads to inefficiently high prices that distort consumption and investment decisions. Two significant policy implications follow. First, the Commission should carefully scrutinize any claims for the recovery of embedded costs in order to ensure that only legitimate claims are allowed. In the absence of such scrutiny, ILECs can be expected to overstate costs, the recovery of which will give rise to efficiency losses with no offsetting public interest benefits. Second, the Commission should carefully design any cost recovery scheme to minimize the resulting economic distortions. In particular, the Commission should pay close attention to the potentially adverse effects on local exchange competition.

B. ILECs Have Economic Incentives to Overstate their Costs

As in any situation in which regulation sets a price ceiling based on costs, ILECs have economic incentives to overstate their costs. If they are successful in raising prices charged to their competitors above economic costs, ILECs will reap financial rewards directly because they will be able to extract revenues in excess of costs and indirectly because they will have succeeded in raising rivals' costs. The latter can be expected to slow the development of local exchange competition and raise equilibrium prices.

Unfortunately, while ILECs have economic incentives to overstate their costs, there is a lack of economic forces limiting the over-recovery of these amounts Under an efficient system of universal service support, competition among carriers seeking subsidies would drive subsidy levels down toward costs. But presumably only ILECs would be eligible to receive subsidies to cover their embedded costs. Hence, there would be no competition or market mechanism to put downward pressure on the amounts paid.